

TENNESSEE GENERAL ASSEMBLY
FISCAL REVIEW COMMITTEE



FISCAL MEMORANDUM

SB 603 – HB 644

April 14, 2015

SUMMARY OF ORIGINAL BILL: Section 1 names the proposed act as the Revenue Modernization Act. Sections 2, 3 and 4 amend the Business Tax Act. Section 2 defines a “substantial nexus in this state” to include taxpayers that have a bright-line presence in Tennessee, which is established if, during a tax period: the taxpayer’s total receipts in Tennessee exceed the lesser of \$500,000 or 25 percent of total receipts everywhere; the average value of the taxpayer’s property owned or rented and used in Tennessee exceeds the lesser of \$50,000 or 25 percent of the average value of all of the taxpayer’s property; or the total compensation paid by the taxpayer in Tennessee exceeds the lesser of \$50,000 or 25 percent of the total compensation paid by the taxpayer. Section 3 authorizes a business tax deduction for the sale of any service that is delivered to a location outside Tennessee, rather than for sales of services that are received by customers located outside Tennessee. Section 4 expands the scope of business activities subject to the business tax by requiring businesses with substantial nexus in Tennessee to pay the business tax, regardless of whether the business has a location in Tennessee.

Sections 5 through 11 amend the Franchise and Excise (F&E) Tax Law. Section 5 defines a “substantial nexus in this state” in a similar manner as section 2 above and also includes taxpayers that license intangible property for use by another party in Tennessee and derives income from that use of intangible property in Tennessee. Section 6 specifies that if a taxpayer disputes the Commissioner of Revenue’s denial of an intangible expense deduction from the net earnings and losses when determining the basis for the excise tax, the taxpayer must show by clear and convincing evidence that the determination is incorrect. Sections 7 and 10 require businesses with substantial nexus in Tennessee, as defined by section 5, to pay the F&E tax. Sections 8 and 11 implement market-based sourcing, instead of earnings-producing activity sourcing, for sales, other than sales of tangible personal property, for purposes of apportioning the F&E tax. Section 9 establishes franchise and excise tax incentive for a taxpayer who moves large volumes of product through third-party distributors if the taxpayer chooses to use distribution centers located in Tennessee. Establishes that, to qualify for the incentive, a taxpayer’s sales of tangible personal property in Tennessee must exceed \$1,000,000,000 and the taxpayer’s receipts factor exceeds 10 percent.

Sections 12 through 16 amend the sales and use tax provisions. Section 12 defines a “video game digital product” as the right to access and use computer software that facilitates human interaction with a user interface to generate visual feedback for amusement purposes, when possession of the computer software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis. Section 13 establishes that, for purposes of the sales and use tax on the use of computer software, such use includes the right to access and use software that remains in the

possession of the dealer who provides the software or in the possession of a third-party on behalf of such dealer. Section 14 subjects video game digital products to sales and use tax. Section 15 declares the legislative intent to impose the sales and use taxes to the fullest extent allowed under the constitutions of the United States and the State of Tennessee. Section 16 creates a presumption that a dealer has a representative in Tennessee and a substantial nexus if: the dealer enters into an agreement with one or more persons located in Tennessee under which the person, for a commission or other consideration, refers potential customers to the dealer; and the dealer's cumulative gross receipts from retail sales made by the dealer to customers in Tennessee who are referred to by the dealer by all residents with this type of an agreement with the dealer exceeds \$10,000 during the preceding 12 months.

Section 17 establishes the severability clause. Section 18 establishes effective dates, as follows: sections 2 through 5, and 7 through 11, shall take effect January 1, 2016, and shall apply to all tax years beginning on or after that date; sections 12 through 14, and 16 shall take effect July 1, 2015; all other sections shall take effect upon becoming a law.

FISCAL IMPACT OF ORIGINAL BILL:

Increase State Revenue – \$17,196,600/FY15-16
\$36,179,100/FY16-17
\$39,869,800/FY17-18
\$45,020,000/FY18-19
\$45,481,700/FY19-20 and Subsequent Years

Increase State Expenditures – \$371,500/FY16-17
\$462,000/FY17-18
\$452,000/FY18-19 and Subsequent Years

Increase Local Revenue – \$7,017,500/FY15-16 and Subsequent Years

The Governor's proposed budget for FY15-16 recognizes a recurring increase in state revenue to the General Fund in the amount of \$14,300,000.

SUMMARY OF AMENDMENTS (006312, 006381): Amendment 006312 deletes all language after the enacting clause. Section 1 names the proposed act as the Revenue Modernization Act. Sections 2, 3 and 4 amend the Business Tax Act. Section 2 authorizes the Commissioner of the Department of Revenue to waive, in whole or in part, any statutory penalty imposed under any laws administered by the Commissioner in any case in which a person fails to procure a license required by law, except when such failure is the result of having been misled by erroneous advice or action on the part of officials charged with the enforcement of this state's tax statutes. Section 3 defines a "substantial nexus in this state" to include taxpayers that have a bright-line presence in Tennessee, which is established if, during a tax period: the taxpayer's total receipts in Tennessee exceed the lesser of \$500,000 or 25 percent of total receipts everywhere; the average value of the taxpayer's property owned or rented and used in Tennessee exceeds the lesser of \$50,000 or 25 percent of the average value of all of the taxpayer's property; or the total compensation paid by the taxpayer in Tennessee exceeds the

lesser of \$50,000 or 25 percent of the total compensation paid by the taxpayer. Establishes that no company that is treated as a foreign corporation under the Internal Revenue Code and that has no income effectively connected with a U.S. trade or business shall be considered to have a substantial nexus in Tennessee. Section 4 authorizes a business tax deduction for the sale of any service that is delivered to a location outside Tennessee, rather than for sales of services that are received by customers located outside Tennessee. Section 5 expands the scope of business activities subject to the business tax by requiring businesses with substantial nexus in Tennessee to pay the business tax, regardless of whether the business has a location in Tennessee.

Sections 6 through 20 amend the Franchise and Excise (F&E) Tax Law. Section 6 defines a “substantial nexus in this state” in a similar manner as section 3 above and also includes taxpayers that license intangible property for use by another party in Tennessee and derives income from that use of intangible property in Tennessee. Adds a net earnings and net worth guidance for the purposes of F&E taxes. Sections 7 and 15 require businesses with substantial nexus in Tennessee, as defined by section 5, to pay the F&E tax. Sections 8, 13 and 16 increase, for tax year beginning on or after July 1, 2016, the weight given to the sales factor under the statutory apportionment formula used to calculate the portion of net earnings and net worth apportioned to Tennessee for F&E tax purposes from a double-weighted factor to a triple-weighted factor. Sections 9 and 17 implement market-based sourcing, instead of earnings-producing activity sourcing, for sales, other than sales of tangible personal property, for purposes of apportioning the F&E tax. Establish that, for any person that is principally engaged in the sale of telecommunications service, mobile telecommunications service, internet access service, video programming service, direct-to-home satellite television programming service, or a combination of such services who, as a member of a qualified group, during the tax period either: incur, in the aggregate as the group, qualified expenditures of more than \$150,000,000, or make sales subject to the sales tax of more than \$150,000,000, total receipts in Tennessee shall equal the receipts from all sales of tangible personal property that are in this state as determined by current law, plus the arithmetical average of the receipts from all sales other than sales of tangible personal property that are in this state as determined under each of the two newly established alternative methods. Sections 10 and 18 establish, regarding F&E apportionment formulas for financial institutions, that receipts equal to the net gain or income from the sale of a security made by a security dealer shall be attributed to Tennessee for F&E tax purposes if such person’s customer is located in Tennessee and such receipt is not otherwise attributed under current law. Sections 11, 12, 19 and 20 update code references. Section 14 establishes franchise and excise tax incentive for a taxpayer who moves large volumes of product through third-party distributors if the taxpayer chooses to use distribution centers located in Tennessee. Establishes that, to qualify for the incentive, a taxpayer’s sales of tangible personal property in Tennessee must exceed \$1,000,000,000 and the taxpayer’s receipts factor exceeds 10 percent.

Sections 21 through 27 amend the sales and use tax provisions. Section 21 defines a “video game digital product” as the right to access and use computer software that facilitates human interaction with a user interface to generate visual feedback for amusement purposes, when possession of the computer software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis. Sections 22 and 24 establish that, for purposes of the sales and use tax on the use of

computer software, such use includes the right to access and use software that remains in the possession of the dealer who provides the software or in the possession of a third-party on behalf of such dealer. Exempt from the sales and use tax any dealer that purchases computer software only for the purpose of reselling access and use of such software. Specify other services exempt from the sales and use tax imposed by this section. Section 23 subjects video game digital products to sales and use tax. Section 25 establishes that the existing sales and use tax exemption of the use of computer software developed and fabricated by an affiliated company is valid regardless of how such software is accessed, used or delivered. Section 26 declares the legislative intent to impose the sales and use taxes to the fullest extent allowed under the constitutions of the United States and the State of Tennessee. Section 27 creates a presumption that a dealer has a representative in Tennessee and a substantial nexus if: the dealer enters into an agreement with one or more persons located in Tennessee under which the person, for a commission or other consideration, refers potential customers to the dealer; and the dealer's cumulative gross receipts from retail sales made by the dealer to customers in Tennessee who are referred to by the dealer by all residents with this type of an agreement with the dealer exceeds \$10,000 during the preceding 12 months.

Section 28 establishes the severability clause. Section 29 establishes effective dates, as follows: section 2 shall take effect July 1, 2016; sections 3 through 7, 14 and 15 shall take effect January 1, 2016, and shall apply to all tax years beginning on or after that date; sections 9 through 12, and 17 through 20 shall take effect July 1, 2016 and shall apply to all tax years beginning on or after that date; sections 21 through 25, and 27 shall take effect July 1, 2015; all other sections shall take effect upon becoming a law.

Amendment 006381 adds a new section (Section 28) which deletes certain provisions regarding the definition of "net earnings" and "net losses" for F&E tax purposes that authorize certain intangible expenses that are paid, accrued or incurred in connection with a transaction with one or more affiliates to be added and subtracted from the net earnings or net losses of certain taxpayers, if approved by the Commissioner or Revenue.

FISCAL IMPACT OF BILL WITH PROPOSED AMENDMENTS:

**Increase State Revenue – Net Impact – \$15,436,600/FY15-16
\$17,111,900/FY17-18
\$11,020,000/FY18-19
\$8,822,700/FY19-20 and Subsequent Years**

Decrease State Revenue – Net Impact – \$7,943,800/FY16-17

**Increase State Expenditures – \$482,100/FY16-17
\$462,000/FY17-18
\$452,000/FY18-19 and Subsequent Years**

Increase Local Revenue – \$7,017,500/FY15-16 and Subsequent Years

The Governor's proposed budget for FY15-16, as amended by the Administration Budget Amendment, recognizes a recurring increase in state revenue to the General Fund in the amount of \$17,200,000.

Assumptions relative to Section 2:

- Based on DOR's analysis of penalties imposed under any laws administered by the Commissioner from FY13-14, it is estimated that the Commissioner will waive \$194,125 in penalties under this section, beginning with FY16-17.

Assumptions relative to Sections 3, 4, and 5:

- Based on an analysis of tax returns in the data warehouse, DOR estimates that applying the substantial nexus standard to the state business tax will result in an increase in state business tax revenue of \$12,916,054.
- The first year impacted will be FY16-17, as the business tax return is due on April 15, 2017, for taxpayers with a tax year beginning on January 1, 2016.
- Because the taxpayers are based out-of-state, DOR anticipates a lag in full compliance. As a result, the compliance is anticipated to be 50 percent in FY16-17, 75 percent in FY17-18, and 100 percent in FY18-19 and subsequent years.
- Taking into account tax return due dates, the increase in state revenue is estimated to be: \$5,534,529 in FY16-17; \$9,225,292 in FY17-18; \$12,454,305 in FY18-19; and \$12,916,054 in FY19-20 and subsequent years.

Assumptions relative to Sections 6, 7, and 15:

- Based on the analysis of estimates of the impact of an economic nexus standard in Connecticut and Washington, DOR estimates that F&E tax collections will increase by approximately 0.26 percent, or \$5,156,060, per year. This estimate is further increased by 10 percent, to a total of \$5,671,666, as it is estimated that triple-weighting the sales factor in the F&E apportionment formula will increase the fiscal impact of these provisions.
- Assuming a similar lag in compliance and taking into account the estimated payments requirements, DOR estimates that the state revenue will increase by: \$4,511,553 in FY16-17; \$4,999,008 in FY17-18; and \$5,671,666 in FY18-19 and subsequent years.

Assumptions relative to Sections 9 and 17:

- Based on the analysis of estimates of the impact of market-based sourcing in Pennsylvania and Massachusetts, DOR estimates that F&E tax collections will increase by approximately 0.515 percent, or \$10,212,965, per year. Increasing this estimate by 10 percent, as above, results in a total increase of \$11,234,262. However, changes impacting qualified members of qualified groups, as defined by this bill, are estimated to reduce F&E tax collections.

- Assuming a similar lag in compliance and taking into account the estimated payments requirements, DOR estimates that the net increase in state revenue will be: \$3,329,978 in FY17-18; \$3,329,978 in FY18-19; and \$4,734,262 in FY19-20 and subsequent years.

Assumptions relative to Sections 8, 13, and 16:

- Based on DOR's static analysis of F&E tax returns for tax periods ending in 2013 and adjusting for the anticipated timing of estimated F&E tax payments, the decrease in state revenue as a result of the F&E formula changes is estimated to be: \$33,232,389 in FY16-17; \$17,444,875 in FY17-18; \$27,438,434 in FY18-19; and \$31,501,800 in FY19-20 and subsequent years.
- There would be a one-time increase in expenditures to DOR of \$110,600 in FY16-17, to accomplish all the technology changes required by this bill as amended. Such changes include, but are not limited to, development of new versions of the F&E tax forms, new versions of keying programs, reformat programs, debit and credit memos, and communication and testing hours in conjunction with the vendors.

Assumption relative to Section 14:

- DOR reports that, based on an analysis of F&E tax returns, the distribution center tax incentive will not result in a decrease in the F&E tax liability for the tax year beginning immediately on or after January 1, 2016, of any registered taxpayer with sales of tangible personal property in the state in excess of \$1,000,000,000 and a receipts factor that exceeds 10 percent.

Assumptions relative to Sections 21 through 25:

- Based on Gartner's data on worldwide and North American software-as-a-service revenue, and assuming that Tennessee represents two percent of the U.S. market, remote access software market in Tennessee is estimated to be approximately \$288,120,000.
- Accounting for the sales to exempt entities and for non-compliance, it is estimated that sales and use taxes will be imposed on 50 percent of such sales, or \$144,060,000.
- Based on PricewaterhouseCoopers LLP and Wilkofsky Gruen Associates analysis of the North American market for online and wireless games, and assuming that Tennessee represents two percent of the U.S. market, video game market in Tennessee is estimated to be approximately \$97,016,000.
- DOR assumes a compliance rate of 25 percent, resulting in taxable sales of approximately \$24,254,000.
- The total taxable sales for remote access software market and video game market are estimated to be \$168,314,000 (\$144,060,000 + \$24,254,000).
- The current state sales tax rate is 7.0 percent; the average local option sales tax rate is estimated to be 2.5 percent; the effective rate of apportionment to local government pursuant to the state-shared allocation is estimated to be 3.617 percent.
- The net recurring increase in state revenue, beginning in FY15-16, is estimated to be \$11,355,826 $[(\$168,314,000 \times 7.0\%) - (\$168,314,000 \times 7.0\% \times 3.617\%)]$.

- The total recurring increase in local revenue, beginning in FY15-16, is estimated to be \$4,634,004 $[(\$168,314,000 \times 2.5\%) + (\$168,314,000 \times 7.0\% \times 3.617\%)]$.

Assumptions relative to Sections 26 and 27:

- Section 26 will not result in a significant fiscal impact.
- The fiscal impact of section 27 (click-through nexus) is dependent upon several unknown factors including, but not limited to, the number of entities that will qualify as dealers under the expanded definition and that will be subject to the sales and use tax, the number of dealers that will conduct operations in Tennessee in the future, the extent to which any associate programs currently operating in this state will be canceled as a direct result of this bill, the extent of taxable sales made by newly designated dealers, and the extent to which the tax is currently collected on internet sales in Tennessee.
- Given the extent of unknown factors, determining a precise fiscal impact is difficult. However, based on information provided by DOR, and projections of the University of Tennessee's Center for Business and Economic Research of state and local revenue losses in Tennessee (\$606,000,000), and assuming that one percent of such losses is recovered as a result of this section, the recurring increase in state and local government revenue, beginning in FY15-16, is estimated to be \$5,840,812 and \$2,383,475, respectively.

Assumptions relative to Amendment 006381:

- Amendment 006381 deletes provisions regarding the definition of "net earnings" and "net losses" for F&E tax purposes that would result in double taxation on intangible expense payments under the Revenue Modernization Act, if not deleted from the F&E tax law, beginning on or after July 1, 2016 (which is the effective date of the market-based sourcing provision of the Act). The original fiscal estimate of the Act assumed that this double taxation would not occur.
- However, this amendment is effective January 1, 2016, and applies to all tax years beginning on or after such date. As a result, and based on information provided by DOR, there will be a decrease in F&E tax collections of approximately \$1,760,000 in FY15-16 and \$1,760,000 in FY16-17.

Assumptions relative to Total Revenue Impacts and State Expenditures:

- The proposed legislation is estimated to result in a net increase in state revenue of: \$15,436,638 $(\$11,355,826 + \$5,840,812 - \$1,760,000)$ in FY15-16; -\$7,943,794 $(\$5,534,529 + \$4,511,553 - \$33,232,389 + \$11,355,826 + \$5,840,812 - \$194,125 - \$1,760,000)$ in FY16-17; \$17,111,916 $(\$9,225,292 + \$4,999,008 + \$3,329,978 - \$17,444,875 + \$11,355,826 + \$5,840,812 - \$194,125)$ in FY17-18; \$11,020,028 $(\$12,454,305 + \$5,671,666 + \$3,329,978 - \$27,438,434 + \$11,355,826 + \$5,840,812 - \$194,125)$ in FY18-19; and \$8,822,695 $(\$12,916,054 + \$5,671,666 + \$4,734,262 - \$31,501,800 + \$11,355,826 + \$5,840,812 - \$194,125)$ in FY19-20 and subsequent years.
- The proposed legislation is estimated to result in an increase in local revenue of: \$7,017,479 $(\$4,634,004 + \$2,383,475)$ in FY15-16 and subsequent years.

- Based on information provided by DOR, it is estimated that due to the expected increase in the number of calls regarding the registration and filing requirements, two additional Taxpayer Services Representative 3 positions will be required, beginning in FY16-17, resulting in a one-time increase in state expenditures of \$11,400 and a recurring increase in state expenditures of \$101,160.
- DOR further informs that two Revenue Enforcement Officer 1 positions will be required, beginning in FY17-18, due to the expected increase in the amount of cases received. The one-time increase in state expenditures is estimated to be \$10,000; the recurring increase in state expenditures is estimated to be \$101,848.
- Two additional Tax Auditor 2–Special positions will be required, beginning in FY16-17, due to the expected increase in out-of-state businesses that are liable for Tennessee taxes. The one-time increase in state expenditures is estimated to be \$10,000; the recurring increase in state expenditures is estimated to be \$248,950.
- The resulting increase in state expenditures is estimated to be \$482,110 (\$11,400 + \$101,160 + \$10,000 + \$248,950 + \$110,600) in FY16-17, \$461,958 (\$101,160 + \$10,000 + \$101,848 + \$248,950) in FY17-18; and \$451,958 (\$101,160 + \$101,848 + \$248,950) in FY18-19 and subsequent years.

CERTIFICATION:

The information contained herein is true and correct to the best of my knowledge.



Jeffrey L. Spalding, Executive Director

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